Issue Paper Number **00-048**

- ☐ Board Meeting
- ☐ Business Taxes Committee
- ☐ Customer Services and Administrative Efficiency Committee
- ☐ Legislative Committee
- ☒ Property Tax Committee
- ☐ Other

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

ASSESSORS' HANDBOOK SECTION 542,
ASSESSMENT OF WATER COMPANIES AND WATER RIGHTS

I. Issue

Should the Board authorize publication of the attached Assessors' Handbook Section 542*, Assessment of Water Companies and Water Rights*; and with respect to Advances for Construction (Advances), should it include:

(a) language stating that Advances contribute to the market value of the appraisal unit; and as such, should be included in the historical cost approach to value; or

(b) language stating that Advances have no value, and therefore should not be included in the historical cost approach to value, as proposed by Industry representatives?

II. Staff Recommendation

1) Authorize publication of Assessors' Handbook Section 542, *Assessment of Water Companies and Water Rights*, with language stating that Advances contribute to the market value of the appraisal unit, and as such, an amount (i.e., the present value of the future payments) should be included in the historical cost approach to value Advances. (Attachment 1.) Language pertaining to Advances is also provided in Attachment 2 under the heading "Staff Recommendation."

2) Authorize the repeal of the current AH 543, *Assessment of Water Rights*, as its subject matter is now contained in the revised version of AH 542, *Assessment of Water Companies and Water Rights*.

III. Other Alternative(s) Considered

Alternative 1:

1) Authorize publication of Assessors' Handbook Section 542*, Assessment of Water Companies and Water Rights*, with language stating that no amount should be included in the historical cost approach to value Advances, as proposed by Industry representatives of the San Gabriel Valley Water Company and the California Water Association. (Attachment 2 under the heading "Industry Proposal.")

2) Authorize the repeal of the current AH 543, *Assessment of Water Rights*, as its subject matter is now contained in the revised version of AH 542*, Assessment of Water Companies and Water Rights*.

IV. Background

Staff was directed to revise the Assessors' Handbook sections related to the appraisal and assessment of water companies and water rights, formerly Assessors' Handbook Sections 542 and 543 respectively. Consistent with this direction, staff drafted an updated version of Assessors' Handbook Section 542 (AH 542) *Assessment of Water Companies and Water Rights*. This draft was distributed in two parts: Part I, Assessment of Water Companies, and Part II, Assessment of Water Rights.

Staff worked with the California Assessors' Association (CAA) and Industry representatives in making changes to the language presented in these drafts and, at this time, agreement has been reached on all language in the draft AH 542 with one exception. Staff and representatives from the San Gabriel Valley Water Company (San Gabriel) and the California Water Association (CWA) are not in agreement regarding the adjustment that should be made to the historical cost less depreciation (HCLD) value indicator for Advances for Construction (Advances), a subject in Part I of AH 542.

Generally, staff and Industry representatives agree that the HCLD value indicator set forth in Property Tax Rule 3(d) is an acceptable method for valuing property interests of rate base regulated utilities because this approach closely parallels the rate base formula on which the California Public Utilities Commission (CPUC) sets rates and the income the utility can earn. Water companies are permitted to recover their cost of service and earn an authorized rate of return following a formula based on historical cost less depreciation. Further adjustments are made under CPUC regulations for specific items to arrive at the owner's net invested capital—often referred to as "rate base." The sum of the cost of providing service, including the recovery of investment, plus earnings (i.e., the allowed rate of return on rate base) determines the total revenue requirements of the utility. The revenue requirements are used to set utility rates charged to customers.

Although staff and Industry representatives agree on the use of HCLD in valuing regulated water companies, there is disagreement regarding the proper adjustment to the HCLD value indicator for Advances. Advances are related only to rate base regulated water companies and represent the value of developer-furnished property that is provided to a utility by a developer or customer under an Advance contract. Regarding Advances:

- A water company will repay the Advance liability, without interest, to the contributor over a 40-year period as required by the CPUC.
- The CPUC adjusts the rate base of the utility so a water company cannot earn a return on assets advanced to the utility.
- A water company is allowed to recover the cost of Advances over a 40-year period from its customers. This increase in revenue provides the utility with the cash to repay the Advance liability over the term of the contract.
- If the Advance contract is retired early, the amount of the payment to the holder of the contract is limited by a termination factor computed by the CPUC.

Staff contends that Advances represent property included in the assets of the water company and contribute value to the water company's appraisal unit. As such, an adjustment should be made to the HCLD indicator to include a value for Advances. Industry representatives contend that Advances do not add value to the utility because the Advances are excluded from rate base by the CPUC and, therefore, have no value for assessment purposes.

Staff's language regarding Advances appears in the complete draft of AH 542 on pages 15-16 and 32-34 of Attachment 1 (and is also shown on Attachment 2 under the heading "Staff Recommendation" for ease of review). Alternative language for inclusion in the draft regarding Advances, as proposed by Industry representatives, is in Attachment 2 under the heading "Industry Proposal."

V. Staff Recommendation

A. Description of the Staff Recommendation

1) Staff recommends that the Board authorize publication of AH 542 including staff's recommended language with respect to Advances (Attachment 1). Specifically, staff's proposed language regarding Advances provides that value for unpaid Advances should be estimated and assessed in accordance with the market value of the property. (Staff's proposed language regarding Advances is shown in Attachment 2 under the heading "Staff Recommendation" for ease of review.)

2) Staff further recommends that the Board authorize the repeal of the AH 543*, Assessment of Water Rights*, as its subject matter is contained in the revised AH 542*, Assessment of Water Companies and Water Rights*.

Staff's position is that Advances contribute value to the appraisal unit as a whole and, as such, should be reflected in the value for property tax assessment purposes. Although a water company is not allowed to earn a return on the property advanced to the utility (i.e., the depreciated cost of this property is excluded from the rate base), it is allowed to recover sufficient cash (i.e., generate revenue) from the ratepayers to pay the Advance liability. Discounting the Advance payments to present value is a reasonable method of measuring the contribution of Advances to the value of the unit. Staff recommends that, when calculating the HCLD value indicator for a regulated water company, the historical cost of Advances should be deducted and the present worth of Advances should be added to arrive at the value of the appraisal unit.

B. Pros of the Staff Recommendation

Publication of this section of the Assessors' Handbook will provide up-to-date information regarding the assessment of water companies and water rights that is not currently available.

The handbook should include staff's recommended language regarding Advances, as it:

- Will reflect the contribution of Advances to the value of the appraisal unit. A prospective investor would assume the liability for unrefunded Advances for the expected future benefits to be received from the Advances (i.e., increased revenues). The entire interest of an entity must be assessed whether represented by equity or debt. If a prospective purchaser/investor would assume a liability for unrefunded Advances, the assumption of such a liability is treated as additional consideration when determining purchase price. The obligation should be treated the same as other debt for property tax purposes, in that the cash equivalent of the debt must be included in a value estimate, even if a sale has not occurred.

- Treats Advances similar to other property that is not included in rate base but which remains taxable for property tax purposes. In calculating the HCLD value indicator, proper appraisal practice (methodology) provides for the exclusion of items in rate base but exempt from property tax and for the inclusion of items not capitalized as fixed assets or otherwise excluded from rate base, yet taxable for property tax purposes. Advances are similar to *noncapitalized* leased property, which although not included in rate base are added to the HCLD value indicator.

- Consistently applies the Board's historical position regarding the assessment of this property and other taxable property not included in rate base. The Board's Valuation Division applies this practice in their valuation of regulated water companies. Assessors' Handbook Section 502, *Advanced Appraisal,* also discusses this appraisal methodology.

C. Cons of the Staff Recommendation

[Industry's Contentions as Summarized by Staff]

By including staff's recommended language regarding Advances, it:

- Ignores the fact that the utility must provide service to all customers within its CPUC certificated service area who request service. CPUC rules require the utility to assume the Advance liability. The utility will be allowed to receive a *return of* the cost of Advances, but not a *return on* the cost of Advances. Advances will only increase rate base, and thus revenues, after the utility has made an additional investment by expending cash to reduce the unrefunded Advance.

- Limits the scope of consideration regarding assessment and value. Staff's proposed language states "ownership, possession, control, or situs alone may determine assessability and value." Legal restrictions that prohibit the utility from earning a return on its investment are as important to consider in assessing the value of water utility property.

- Compares Advances to leased property by stating "the status of payment does not determine assessability." Unlike Advances, water utilities are allowed to earn a return on leased properties that are capitalized. Advances do not have a present worth greater than net book value because utilities are prohibited from earning a return on their investment, not because of the payment status. Even if payment status were to be considered, CPUC Rule 15 prohibits a utility from purchasing an Advance contract (without prior CPUC approval) for the first 10 years and establishes the maximum price that a utility may pay through termination factors contained within the Rule.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

None

2. Revenue Impact

There is no revenue effect under the staff's recommendation since it would continue current practice.

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

Distribution of the revised manual is scheduled for January 2001. In order to meet this deadline, the draft of AH 542 must be approved for publication by the Board at its December 2000 meeting.

VI. Alternative 1

A. Description of Alternative 1

1) Authorize publication of Assessors' Handbook Section 542*, Assessment of Water Companies and Water Rights*, with language stating that no amount should be included in the historical cost approach to value Advances. (Industry's proposed text is shown on Attachment 2 with changes to staff's recommended text identified in strike out and underline format under the heading "Industry Proposed Text.")

2) Repeal the current AH 543, as its subject matter is contained in the revised AH 542*, Assessment of Water Companies and Water Rights*.

Industry's proposed language regarding Advances modifies the Board staff's proposed language by deleting all discussion and examples indicating that Advances have a present worth greater than the value used to compute rate base under CPUC rate setting rules. Industry believes that their proposed language is consistent with CPUC rules, public utility accounting, and investor's treatment of Advances. Industry further believes that the economic principles established by these rules must be taken into account when valuing utility property for property tax assessment purposes. Industry contends that no value should be added for Advances when calculating the HCLD value indicator.

B. Pros of Alternative 1

[*Industry's Contentions as Summarized by Staff*]

Inclusion of Industry's proposed language regarding Advances is appropriate, as it:

- Treats Advances and Contributions in Aid of Construction (CIAC) similarly when calculating the HCLD value indicator. CIAC is property donated or given to a utility in order to induce them to connect to or provide service to a customer's project. CIAC is similar to Advances in that CPUC rules do not allow the utility to earn a "return on" the CIAC. Thus, the underlying economics of CIAC and Advances are the same. However, staff's language treats these items differently by providing that CIAC should be subtracted when calculating the HCLD value indicator for a regulated water company, while providing that an amount should be added to the HCLD value indicator for Advances.

- Reflects the requirements of Property Tax Rule 3(d) regarding the application of the HCLD approach. Rule 3(d) states in part: "the amount invested in the property or the amount invested less depreciation <u>computed by the method employed by the regulatory agency (the historical cost approach)</u>." [Emphasis added.] Rule 3(d) does not provide in any way for increasing value beyond the CPUC method when applying this approach. It specifically requires that the method employed by the regulatory agency be used in determining the assessed value of a utility's property.

- Reflects the fact that CPUC rules do not allow a utility to earn a "return on" the property advanced; therefore, a prospective purchaser would not pay for such property. Although CPUC rules allow depreciation resulting from the property advanced as a revenue requirement when setting rates, utilities are in no way enriched by the higher rates resulting from depreciation of Advances because this revenue is used to make the annual 2.5 percent refunds as required by CPUC Rule 15. Utilities merely act as a conduit, transferring funds from customers to those who make Advances.

- The following example, computing value using the income approach as presented in proposed AH 542, provides further evidence that a present worth should not be placed on Advances, as this approach and the HCLD method employed by the CPUC produce the same result of zero:

Income Approach Computation
Perpetual Life Model
Advances of $65,000

Anticipated Revenue	$65,000
Less: Estimated Capital Replacement Expenditure	<65,000>
Appraisal Income	-0-
Capitalization Rate (assumed 15%)	15%
Income Approach Value Indicator	-0-

C. Cons of Alternative 1

[Staff's Contentions]

- The effect of Industry's proposal is to treat Advances and contributions (CIAC) identically even though the rate making treatment of Advances and contributions differs. CIAC differs from Advances in that the utility will not repay the contributor for the property and the property will not eventually be added to rate base. CIAC property adds no value to the unit since no liability is associated with this type of property and there is no effect on the revenue that the utility is allowed to generate. Therefore, the assessable value of CIAC property is zero. Advances do increase the allowable revenue of a utility while contributions (CIAC) do not.

- Industry misinterprets Rule 3(d) by interpreting the phrase "computed by the method employed by the regulatory agency" to mean assessable value equals rate base. HCLD is not equal to rate base. As stated in the *Unitary Valuation Methods* book,

  > "The Historical Cost Less Depreciation (HCLD) value indicator derivation includes the historical or original acquisition cost of all property less nontaxable items and property assessed elsewhere. This results in the taxable historical cost. The taxable historical cost is then reduced for the assessee's regulatory accounting depreciation of the taxable property. This results in the assessable HCLD. The value of any…noncapitalized leased properties are added to arrive at the final HCLD value indicator."

  As such, Rule 3(d) only requires the use of depreciation as computed by the regulatory agency (i.e., CPUC) when computing the HCLD value indicator.

- Although Industry agrees that a water utility would be allowed to recover the cost of Advances to the utility, Industry values these cash flows at zero. This has the effect of valuing only the equity interest in the property, which is in conflict with appraisal theory. A utility may not earn a *return on* Advances, but they *do* earn a *return of* Advances. For rate base purposes, depreciation may offset the return of the Advances for net income. For appraisal purposes, however, depreciation is not an allowable adjustment in the determination of net income. This additional revenue provides sufficient cash to retire the liability and must be considered in the determination of fair market value.

- Industry's example reflecting the value of Advances as zero is flawed in that it equates the capital replacement allowance allowed by Rule 8(c) with the payment of the Advance liability. Advance payments are equivalent to principal payments on debt, which are not allowed as outgo under Rule 8(c). Actual replacements of Advances would increase the rate base and would be properly included in a subsequent rate base at cost.

D. Statutory or Regulatory Change

None

E. Administrative Impact

None

F. Fiscal Impact

1. Cost Impact

None

2. Revenue Impact

The estimated annual decrease in revenues at the basic one percent property tax rate under alternative 1 ranges from $581,000 to $2,518,000.

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

Distribution of the revised manual is scheduled for January 2001. In order to meet this deadline, the draft of AH 542 must be approved for publication by the Board at its December 2000 meeting.

Prepared by: Property Taxes Department; Policy, Planning, and Standards Division; and Legal Division, Property Taxes Section.

Current as of: November 27, 2000

STAFF'S RECOMMENDED DRAFT

ASSESSORS' HANDBOOK
SECTION 542

ASSESSMENT OF WATER COMPANIES AND WATER RIGHTS

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
1.	Page 15, Line 17 through Page 16, Line 11	**Advances for Construction** *Advances for Construction (Advances)* represents funds for the construction of property or the value of developer-furnished property which are provided to a utility by a developer or customer under an Advance contract. For example, developers may give Advances to utilities in order for the utility to connect to or provide service to their projects. Advances are similar to CIAC, except that the utility will eventually pay for the Advances, and costs are recoverable over the life of the property. (FN) The utility refunds the Advances to the developers or customers over a stipulated period of time (i.e., 40 years) with no interest. Advances are added to the rate base as the Advances are paid by the utility. Property paid for with Advances or received as Advances is considered assessable property, although the property is not included in rate base until refunded by the utility. The value of Advances should reflect the present market or full cash value of the property and should be added to the total assessed value of the remainder of the appraisal unit, similar to CIP that has yet to affect rate base, if it adds value to that unit. Similar to leased property, the status of payment does not determine assessability. Ownership, possession, control, or situs alone may determine assessability and value. In estimating the present worth of Advances, appraisers and auditor-appraisers should consider all approaches to value and whether or not an Advance adds value to the appraisal unit as a whole. Although regulations limit the income generating capability of this type of property (i.e., Advances are not included in the rate base established by the CPUC until repaid) and provide a limitation that the contract may only be repaid or terminated according to CPUC requirements (CPUC Rule 15) or approval, if a potential investor would assume a	**Advances for Construction** *Advances for Construction (Advances)* represents ~~funds for the construction of property or the value of~~ money expended by a developer or customer in order to receive service. (FN) -~~furnished property which are provided to a utility by a developer or customer under an Advance contract.~~ For example, developers may give Advances to utilities in order for the utility to connect to or provide service to their projects. Advances are similar to CIAC in that the utility is prohibited from earning a return on Advanced property. ~~, except that the utility will eventually pay for the Advances, and costs are recoverable over the life of the property.~~ (FN) The utility is allowed to recover revenue equal to depreciation of the property advanced but must refund the amount Advanced to the developer or customer~~. refunds the Advances to the developers or customers over a stipulated period of time (i.e., 40 years) with no interest. Advances are added to the rate base as the Advances are paid by the utility.~~ CPUC rules provide that Advances shall be refunded by the utility, in cash, without interest for a period not to exceed 40 years after the date of contract. The rules further provide that the utility shall annually refund an amount equal to 2.5 percent of the Advances until the principal amounts of the contracts have been full repaid. The unrefunded balance of Advances declines as a result of the cash refunds to the developer or customer resulting in a matching increase in rate base, offset by an increase in accumulated depreciation leaving rate base essentially unchanged. ~~Property paid for with Advances or received as Advances is considered assessable property, although the property is not~~

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
		liability (FN) for unrefunded Advances, it is treated as additional consideration when determining purchase price and indicative of value. The value of property purchased with Advances most likely reflects these limitations. In general, value for Advances is only added to a value indicator when the HCLD approach is utilized. (See Chapter 3, page xx, for more information regarding the valuation of Advances and HCLD.) Adding value for Advances is unnecessary when using the income approach, as the income utilized in this approach includes income expected to be earned in relation to this property. Footnote Text: (FN) Account 241 (Class A) or account 252 (Classes B, C, D) in the Uniform System of Accounts. Any balances in this account not refunded in accordance with the utility's water main extension rules, are required to be transferred to account 265 (Class A) or account 271 (Classes B, C, D), *Contributions in Aid of Construction*. (FN) "Debt" must be converted to its cash equivalent when estimating value (Section 110, Rule 4(b)).	~~included in rate base until refunded by the utility. The value of Advances should reflect the present market or full cash value of the property and should be added to the total assessed value of the remainder of the appraisal unit, similar to CIP that has yet to affect rate base, if it adds value to that unit. Similar to leased property, the status of payment does not determine assessability. Ownership, possession, control, or situs alone may determine assessability and value.~~ When HCLD is a valid indicator, Advances, similar to CIAC, generally have a zero value for property tax assessment purposes because CPUC rules do not allow the utility to earn a "return on" the property advanced. Therefore, a prospective purchaser would not pay for Advanced property. A knowledgeable public utility investor's only expectation is to receive a "return of" the investment made on property acquired as a result of Advances, as CPUC rules prohibit the utility from earning a "return on" Advances. ~~In estimating the present worth of Advances, appraisers and auditor-appraisers should consider all approaches to value and whether or not an Advance adds value to the appraisal unit as a whole. Although regulations limit the income generating capability of this type of property (i.e., Advances are not included in the rate base established by the CPUC until repaid) and provide a limitation that the contract may only be repaid or terminated according to CPUC requirements (CPUC Rule 15) or approval, if a potential investor would assume a liability (FN) for unrefunded Advances, it is treated as additional consideration when determining purchase price and indicative~~

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
			~~of value. The value of property purchased with Advances most likely reflects these limitations.~~ ~~In general, value for Advances is only added to a value indicator when the HCLD approach is utilized. (See Chapter 3, page xx, for more information regarding the valuation of Advances and HCLD.) Adding value for Advances is unnecessary when using the income approach, as the income utilized in this approach includes income expected to be earned in relation to this property.~~ Footnote Text: (FN) Account 241 (Class A) or account 252 (Classes B, C, D) in the Uniform System of Accounts. Any balances in this account not refunded in accordance with the utility's water main extension rules, are required to be transferred to account 265 (Class A) or account 271 (Classes B, C, D), *Contributions in Aid of Construction*. ~~(FN) "Debt" must be converted to its cash equivalent when estimating value (Property Tax Rule 4(b), Revenue and Taxation Code section 110).~~
2.	Page 30, Line 7	*A change to Attachment 1 is appropriate only if Industry proposal regarding Matrix item #1 and #5 are accepted.*	Revise sentence: "…contributions in aid of construction and Advances) that would have no value
3.	Page 30, Example 3.1	*A change to Attachment 1 is appropriate only if Industry proposal regarding Matrix item #1 and #5 are accepted.*	Add as additional adjustments under "Contributions in Aid of Construction (CIAC)": Advances (65,000)

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
4.	Page 32 Footnote 75	*A change to Attachment 1 is appropriate only if Industry proposal regarding Matrix item #1 and #5 are accepted.*	Revise footnote: “Example 3.1 illustrates the exclusion of CIAC and Advanced property in determining the historical cost of assessable property. Although technically assessable property CIAC, and Advances generally add no additional value to the unit and ~~is~~ are therefore excluded in the first step of the valuation process.
5.	Page 32, Line 23 through Page 34, Line 9	**Advances for Construction** *Advances for Construction (Advances)* represents funds for the construction of property or the value of developer-furnished property which are provided to a utility by a developer or customer under an Advance contract. For example, developers may give Advances to utilities in order for the utility to connect to or provide service to their projects. Advances are similar to CIAC, except that the utility will eventually pay for the Advances, and costs are recoverable over the life of the property.(FN) The utility refunds the Advances to the developers or customers over a stipulated period of time. CPUC rules provide that the amount advanced shall be refunded by the utility, in cash, without interest for a period not to exceed 40 years after the date of the contract. The CPUC rules further provide that the utility shall annually refund an amount equal to 2.5 percent of the Advances until the principal amounts of the contracts have been repaid. As an example, a building developer may pay a water company for the installation of water lines to the builder’s subdivision. The water utility would then slowly refund the amount advanced by the developer. Advances are added to the rate base as the Advances are paid by the utility. In calculating the HCLD value indicator for the property of a regulated	**Advances for Construction** *Advances for Construction (Advances)* represents ~~funds~~ money expended by a ~~for the construction of property or the value of~~ developer or customer in order to receive service. (FN)~~-furnished property which are provided to a utility by a developer or customer under an Advance contract.~~ For example, developers may give Advances to utilities in order for the utility to connect to or provide service to their projects. Advances are similar to CIAC in that the utility is prohibited from earning a return on Advanced property~~.~~ ~~, except that the utility will eventually pay for the Advances, and costs are recoverable over the life of the property.(FN)~~ The utility is allowed to recover revenue equal to depreciation of the property advanced but must refund the amount Advanced to the developer or customer. ~~refunds the Advances to the developers or customers over a stipulated period of time.~~ CPUC rules provide that Advances ~~the amount advanced~~ shall be refunded by the utility, in cash, without interest for a period not to exceed 40 years after the date of the contract. The ~~CPUC~~ rules further provide that the utility shall annually refund an amount equal to 2.5 percent of the Advances until the principal amounts of the contracts have been repaid.

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
		utility, the historical cost of the Advances should be deducted and the present worth of the Advances should be added to arrive at a value estimate for the entire property of the company (see Example 3.5). In estimating the present worth of Advances, appraisers and auditor-appraisers should consider all approaches to value and whether or not the property adds value to the appraisal unit as a whole. Both the liability associated with the unpaid Advances,(FN) and the market should be considered. Regulations limit the income generating capability of this type of property (i.e., Advances are not included in the rate base established by the CPUC until repaid) and provide a limitation that the contract may only be repaid or terminated according to CPUC requirements (CPUC Rule 15) or approval. The value of property purchased with Advances most likely reflects these limitations. The multiplication of the remaining unrefunded contract balance and the termination factors (FN) established by CPUC Rule 15 equals the maximum price that may be paid by the utility to terminate a contract, at any point in time. Such a price may be used to estimate the present value of Advances. The following example utilizes the termination factors to estimate value based on the facts presented. **EXAMPLE 3.3** **PRESENT WORTH OF ADVANCES FOR CONSTRUCTION** The balance of Account 252, *Advances for Construction*, is $65,230 on the lien date. The termination date is 13 years away. What is the present market value (assessable value) of the Advances? $ 65,230 x .4941 = **$ 32,230** Advances *must* be refunded within a 40 year period, and *may* be "purchased by the utility and terminated, provided the payment is not in excess of the estimated revenue refund multiplied by the	As an example, a building developer may pay a water company for the installation of water lines to the builder's subdivision. The unrefunded balance of Advances declines as a result of the cash refunds to the developer or customer resulting in a matching increase in rate base, offset by an increase in accumulated depreciation leaving rate base essentially unchanged. ~~The water utility would then slowly refund the amount advanced by the developer. Advances are added to the rate base as the Advances are paid by the utility.~~ ~~In calculating the HCLD value indicator for the property of a regulated utility, the historical cost of the Advances should be deducted and the present worth of the Advances should be added to arrive at a value estimate for the entire property of the company (see Example 3.5). In estimating the present worth of Advances, appraisers and auditor-appraisers should consider all approaches to value and whether or not the property adds value to the appraisal unit as a whole. Both the liability associated with the unpaid Advances,(FN) and the market should be considered. Regulations limit the income generating capability of this type of property (i.e., Advances are not included in the rate base established by the CPUC until repaid) and provide a limitation that the contract may only be repaid or terminated according to CPUC requirements (CPUC Rule 15) or approval. The value of property purchased with Advances most likely reflects these limitations.~~ ~~The multiplication of the remaining unrefunded contract balance and the termination factors (FN) established by CPUC Rule 15 equals the maximum price that may be paid by the utility to terminate a contract, at any point in time. Such a price~~

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
		termination factor" (CPUC Decision 82 01 82). A prospective investor would consider this fact, and/or be limited by these conditions when determining a current "value" of (or liability associated with) such property and when considering a purchase; therefore, application of the termination factors is deemed appropriate and may estimate the value of Advances to the market. However, another method of valuation may more accurately represent the market value of Advances. For example, net book value and a discounted cash flow estimate may both be considered. The appropriate value, reflective of the market, should be added to the total value of the remainder of the appraisal unit if Advances add value to that appraisal unit. In summary, when calculating a final HCLD value indicator, the historical cost of the Advances should be deducted, and the present worth of the Advances should be added (see Example 3.4). As mentioned above, the present worth (i.e., the market value, assessable value) of Advances should be estimated using a methodology appropriate to the market for, and the limitations imposed upon, that property. (FN) <u>Footnote Text:</u> (FN) Account 241 (Class A) or account 252 (Classes B, C, D) in the Uniform System of Accounts. Any balances in this account not refunded in accordance with the utility's water main extension rules, are required to be transferred to account 265 (Class A) or account 271 (Classes B, C, D), *Contributions in Aid of Construction*. (FN) Debt" must be converted to its cash equivalent when estimating value	~~may be used to estimate the present value of Advances. The following example utilizes the termination factors to estimate value based on the facts presented.~~ ~~**EXAMPLE 3.3**~~ ~~**PRESENT WORTH OF ADVANCES FOR CONSTRUCTION**~~ ~~The balance of Account 252, *Advances for Construction*, is $65,230 on the lien date. The termination date is 13 years away.~~ ~~What is the present market value (assessable value) of the Advances?~~ ~~$ 65,230 x .4941 = **$ 32,230**~~ ~~Advances *must* be refunded within a 40 year period, and *may* be "purchased by the utility and terminated, provided the payment is not in excess of the estimated revenue refund multiplied by the termination factor" (CPUC Decision 82 01 82). A prospective investor would consider this fact, and/or be limited by these conditions when determining a current "value" of (or liability associated with) such property and when considering a purchase; therefore, application of the termination factors is deemed appropriate and may estimate the value of Advances to the market.~~ ~~However, another method of valuation may more accurately represent the market value of Advances. For example, net book value and a discounted cash flow estimate may both be considered. The appropriate value, reflective of the market, should be added to the total value of the remainder of the appraisal unit if Advances add value to that appraisal unit.~~ ~~In summary, w~~<u>W</u>hen ~~calculating a final~~ HCLD <u>is a valid</u> ~~value~~ indicator, ~~the historical cost of the~~ Advances ~~should be deducted, and the present worth of the Advances should be~~

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
		(Property Tax Rule 4(b), Revenue and Taxation Code section 110). (FN) See Appendix E. (FN) See also AH 502, *Advanced Appraisal*, Chapter 2 for a detailed discussion of the standard of value for assessment purposes.	~~added (see Example 3.4). As mentioned above, the present worth (i.e., the market value, assessable value) of Advances should be estimated using a methodology appropriate to the market for, and the limitations imposed upon, that property. (FN)~~ When HCLD is a valid indicator, Advances, similar to CIAC, generally have a zero value for property tax assessment purposes because CPUC rules do not allow the utility to earn a "return on" the property advanced. Therefore, a prospective purchaser would not pay for Advanced property. A knowledgeable public utility investor's only expectation is to receive a "return of" the investment made on property acquired as a result of Advances, as CPUC rules prohibit the utility from earning a "return on" Advances. Footnote Text: (FN) Account 241 (Class A) or account 252 (Classes B, C, D) in the Uniform System of Accounts. Any balances in this account not refunded in accordance with the utility's water main extension rules, are required to be transferred to account 265 (Class A) or account 271 (Classes B, C, D), *Contributions in Aid of Construction*. ~~(FN) Debt" must be converted to its cash equivalent when estimating value (Property Tax Rule 4(b), Revenue and Taxation Code section 110).~~ ~~(FN) See Appendix E.~~

SUMMARY OF WORDING DIFFERENCES REGARDING ADVANCES FOR CONSTRUCTION

No..	Reference to Attachment 1 (Part I)	Staff Recommendation (as shown in Attachment 1)	Industry Proposal (proposed to replace text in Attachment 1)
			~~(FN) See also AH 502, *Advanced Appraisal*, Chapter 2 for a detailed discussion of the standard of value for assessment purposes.~~
6.	Page 33, Footnote 78	*A change to Attachment 1 is appropriate only if Industry proposal regarding Matrix item #1 and #5 are accepted.*	Delete footnote
7.	Page 36, Example 3.4	*A change to Attachment 1 is appropriate only if Industry proposal regarding Matrix item #1 and #5 are accepted.*	Change lines as follows: Advances for Construction ~~(see Example 3.3)~~ (65,230) ~~Less: Historical Cost of Advances (65,000)~~ ~~Plus: Present Worth of Advances 32,116~~
8.	Page 86, Lines 12-16 Appendix D	*A change to Attachment 1 is appropriate only if Industry proposal regarding Matrix item #1 and #5 are accepted.*	Delete lines 12, 14, and 15. Move line 13 to left margin.
9.	Page 90 Appendix E	*A change to Attachment 1 is appropriate only if Industry proposal regarding Matrix item #1 and #5 are accepted.*	Delete Appendix E in its entirety.

BOARD OF EQUALIZATION
REVENUE ESTIMATE

ISSUE #00-048
ASSESSORS' HANDBOOK SECTION 542
ASSESSMENT OF WATER COMPANIES AND WATER RIGHTS

Staff Recommendation

Under the staff's recommendation, the Board would authorize publication of the Assessors' Handbook Section 542, *Assessment of Water Companies and Water Rights.* Staff's recommended handbook section will replace AH 542, Assessment of Water Companies, no longer in publication, and the current AH 543, Assessment of Water Rights, in circulation.

Alternative 1

Under the alternative proposed by Industry, the Board would authorize publication of the Assessors' Handbook Section 542, *Assessment of Water Companies and Water Rights*, with the exception that passages related to Advances for Construction (Advances) would be replaced with the Industry version of those passages.

Background, Methodology, and Assumptions

Under current practice, values for unpaid Advances are estimated and assessed in accordance with the market value of the property, considering the limitations placed on the property by the California Public Utility Commission (CPUC). There is no revenue effect under the staff's recommendation since it would continue current practice.

Under alternative 1, the language proposed by Industry modifies the staff proposed language by deleting all discussion and examples indicating that Advances have a present worth greater than the value used to compute the rate base under CPUC rate setting rules. Since Advances are not a factor in computing rate base, the value for unpaid Advances would not be recognized in determining the assessed values of water utilities.

According to data obtained from CPUC, unpaid Advances for the largest water utilities amount to nearly $282 million. The present worth of these Advances can be estimated using CPUC termination factors; these range from .2061 for a brand-new Advance to .8929 for an Advance with only one year remaining in its 40-year term. The estimated present worth of these advances is then between $282 million x .2061 and $282 million x .8929, or between $58.1 million and $251.8 million. Under alternative 1, property tax revenues at the basic one percent tax rate would decrease by $58.1 million x one percent to $251.8 million x one percent, or between $581,000 and $2,518,000.

Revenue Summary

There is no revenue effect under the staff's recommendation since it would continue current practice. The estimated annual decrease in revenues at the basic one percent property tax rate under alternative 1 ranges from $581,000 to $2,518,000.

Preparation

This revenue estimate was prepared by Aileen Takaha Lee, Research and Statistics Section, Agency Planning and Research Division. The estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division, and by Mr. Richard Johnson, Deputy Director, Property Taxes Department. For additional information, please contact Ms. Lee at 445-0840.

Current as of December 1, 2000.